Supreme Court of the United States

OCTOBER TERM 1944

No. 137

PRUDENCE REALIZATION CORPORATION,

Petitioner,

vs.

JOSEPH W. FERRIS, GEORGE L. LONG and HENRY LEIFERT as Trustees under a Declaration of Trust dated as of July 1st, 1938, with respect to 307 West 36th Street (Burnside) First Mortgage Participation Certificates, CITY BANK FARMERS TRUST COMPANY and MARTIN S. LINDGROVE as Trustees under the Last Will and Testament of Herman Stutzer, deceased, on behalf of themselves and other holders of certificates in 307 West 36th Street (Burnside) First Mortgage Participation Certificates, SOLOMON ZAUDERER, MILTON KIMMELMAN, IRVING ZAUDERER and CHARLES KIMMELMAN, doing business as KIMMELMAN AND ZAUDERER, on behalf of themselves and all other holders of Prudence Bonds Corporation participating certificate issue, and HUNTER L. DELATOUR, RAYMOND REISLER and JEROME THRALLS, Trustees of Realty Associates Securities Corporation, Debtor, holders of Burnside Certificates.

REPLY BRIEF ON BEHALF OF PRUDENCE REALIZATION CORPORATION, PETITIONER

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REPLY BRIEF ON BEHALF OF PRUDENCE REALIZATION CORPORATION, PETITIONER

I

As to the brief of respondents Ferris, Long and Leifert.

1. These respondents contend that no federal question is involved because the Court of Appeals decided that neither the plan of reorganization nor any order in the

reorganization proceeding undertook to modify the legal rights of the parties and that therefore the question should be determined unaffected by the reorganization proceedings as if there had been no insolvency or bankruptcy.

In the first place, the relative rights of petitioner and other holders were specifically modified by the plan. The plan provided that if the Prudence certificates were not entitled to parity, then the income which would have been payable on the certificates should be distributed one-half to other certificate holders and one-half to the sinking fund for the purchase of certificates. The fact is that the "court of competent jurisdiction" was required merely to interpret the provisions of the plan providing for adjudication of the question whether the Prudence certificates were or were not entitled to parity. It could not determine that question unaffected by the reorganization because the provision in the plan for the disposition of the income was on a basis wholly inconsistent with state law. Thus, it could not have been contemplated by the plan, as held by the Court of Appeals, that the controversy should go to the state court for determination unaffected by the reorganization. On the contrary, no matter what the forum was, it was necessary to interpret the rights of the parties under the plan of reorganization in bankruptcy. Such a question necessarily could not be unaffected by the reorganization proceeding.

Secondly, even if the plan itself did not specifically provide for the distribution of the fund dependent upon whether or not the Prudence certificates were entitled to parity, there would still remain the question of the effect the bankruptcy had on what otherwise would have been the rights of the parties.

The determination of the effect of bankruptcy is a matter properly within the jurisdiction of the federal court and an adjudication by a state court as to the effect of such bankruptcy therefore is necessarily a matter of federal law determinable in accordance with federal rather than state decisions. *Local Loan Co.* v. *Hunt*, 292 U. S. 234.

The argument made by these respondents as to what the result would have been had the question of parity been litigated prior to the bankruptcy of the guarantor is academic, for the fact is in the present case that the guarantor became a bankrupt and that it was reorganized exclusively for the benefit of its creditors. This argument is predicated solely upon the assumption, upon which the New York Court of Appeals also relied, that the fact of the bankruptcy is of no moment and that rights may be adjudicated by a state court without regard to the bankruptcy.

These respondents also urge that a right of priority in property of a creditor may not be lost through the mere institution of a proceeding in bankruptcy. However, it is clear, rights granted by state statute or decision may not control the operation of the federal statute such as the Bankruptcy Act and that such rights granted by state law will be recognized only to the extent that they are not inconsistent with the language or the spirit of the federal statute. *Sola Electric Co.* v. *Jefferson Electric Co.*, 317 U. S. 173, 176; *Wragg* v. *Federal Land Bank of New Orleans*, 317 U. S. 328; *City of New York* v. *Feiring*, 313 U. S. 283; *City of New York* v. *Hall* (C. C. A. 2d, 1944), 139 F. (2d) 935, 936.

On page 7 of respondents' brief, they concede that petitioner had the right to institute the litigation for the determination of the parity question. They draw the conclusion, however, from the failure of petitioner to institute suit in the federal court, that petitioner concedes that the matter was one for adjudication by the state court as a matter of state law. The fact is, that prior to the institution of the present action, however, petitioner was engaged as a respondent in federal court litigation involving the same question which had been similarly reserved, and in that litigation urged that the question of parity was reserved as a question of federal law, determinable in accordance with the Bankruptcy Act. *Prudence Realization Corporation* v. *Geist*, 316 U. S. 89. Moreover,

in the present litigation the answers of petitioner urge that the question is one of federal law. That position has been continuously maintained and was upheld by the unanimous decision of the Appellate Division of the State of New York. *Ferris* v. *Prudence Realization Corporation*, 266 App. Div. 543.

2. At page 8 of their brief, these respondents seek to distinguish the decision of this Court in *Prudence Realization Corporation* v. *Geist*, *supra*, upon the erroneous assumption that the application by the trustee for the determination of the parity question in that case was in the nature of a request to modify or change the plan. It is evident that since the trustee in the *Geist* case was not a reorganization trustee but the trustee appointed after the confirmation of the plan, he was not "a party in interest" authorized to propose amendments to the plan. National Bankruptcy Act, Section 77B (f), 11 U. S. C. A., § 207 (f). Nor can any familiarity with reorganization practice justify an assumption that an application for a determination that petitioner's certificates were subordinate, which application was made on notice solely to petitioner, was a proposed amendment or modification of the plan of reorganization.

Respondents also devote several pages of their brief to the argument that the Burnside plan may not be collaterally attacked. It is submitted, however, that urging that the parity question be determined as a matter of federal law is not in the nature of a collateral attack upon the plan of reorganization. Petitioner's position is that the question of parity, determination of which is required by a federal plan of reorganization, shall be determined in accordance with the federal law. The respondents, however, are urging that the question be determined not alone as a matter of state law, but in complete disregard of the federal plan of reorganization and the federal bankruptcy proceeding itself. The attack on the Burnside plan, if any there be, is not in any sense collateral, but is direct in character and is directed solely by respondent.

II

As to the brief of respondents City Bank Farmers Trust Company and Lindgrove.

Before discussing these respondents' arguments addressed to the merits of the petition, accuracy requires that several statements of fact in their brief be clarified.

1. At pages 4 and 5 of their brief, in referring to the "New Loan Value" formula adopted as part of the plan of reorganization for the guarantor, respondents assert that this formula approximated the method in the New York state court reorganizations.

However, the precise question was presented to the New York Court of Appeals, which held in *Matter of New York Title and Mortgage Co.*, 277 N. Y. 66, that such a formula was improper under New York law and prohibited its use in state court reorganizations.

2. At page 12 of their brief, in discussing the reservation in the *Zo-Gale* reorganization, which was the subject of litigation in this Court in *Prudence Realization Corporation* v. *Geist*, *supra*, respondents state that in that case, "the only reservation was contained in the order confirming the Plan, when the Court, in closing the *Zo-Gale* proceeding, reserved jurisdiction to try the bankruptcy issue then pending undecided before it". Again, at page 13 of their brief, they state that the "reservation contained in the order closing the *Zo-Gale* proceeding was not part of the Plan, * * *."

Although in each instance respondents have inferred that the reservation of the parity question in the *Zo-Gale* case was contained in the order "closing the case", the fact is to the contrary. The reservation was contained in the order confirming the *Zo-Gale* plan (*Prudence Realization Corporation* v. *Geist*, *supra*, Case on Appeal R. 6).

The reservation in the order closing the Amalgamated proceeding (R. 193-195) to which these respondents apparently refer, did not reserve the parity question for determination by the federal court, but held for disposition the pending motion made by trustee in the *Zo-Gale* case for its determination, which motion had been made pursuant to the reservation in the *Zo-Gale* case (R. 193-195).

3. At page 14 of their brief, these respondents assert that the question of parity was reserved in the *Zo-Gale* case by the court itself in its own order, as part of the bankruptcy proceeding, and that distribution was to be made "in accordance with the final adjudication of such court".

In the *Zo-Gale* case the order of confirmation was submitted by the parties in the form finally signed by the court. Parity reservation was agreed upon by the parties and not inserted by the court on its own motion. It was substantially identical with the reservation contained in the *Burnside* proceeding where, in lieu of inserting it directly in the order of confirmation, since there were a substantial number of amendments to be made to the plan relating to other matters, such amendments were drawn up separately, included as an exhibit, and approved by the court in its order of confirmation. The time sequence, therefore, is exactly the same in each case with respect to the approval of the court and the question of consent.

The assertion that distribution was to be made in accordance with the determination of only the reorganization court is self-evidently fallacious. The quotation contained in respondents' brief above referred to has been taken out of context, for reference to that portion of the record to which they have referred (R. 184), will show that the phrase "such court" refers to the "court of competent jurisdiction" for whose adjudication the parity question was reserved, and was not limited to the reorganization court.

Proceeding to the merits, these respondents argue three main grounds upon which the petition should be denied, and which will be separately treated:

1. They also contend that since the bankruptcy court did not pass on it, the determination of the parity question was relegated to its status prior to and unaffected by the insolvency of either the guarantor or the certificate issue, and is determinable as a matter of state law. In support they point to the fact that the form of distribution agreed upon in the event of a determination of subordination was contrary to the federal bankruptcy rule of distribution.

As previously indicated under I of this brief, however, the supporting argument destroys respondents' premise, for the agreed upon procedure for distribution is directly contrary to the subordination requirements under state law. Respondents' argument is therefore that the federal plan didn't pass on the parity question, but disposed of the rights of the parties by an agreement entered into in accordance with federal procedure, leaving, however, to the state court as a matter of state law the determination merely as to whether the creditors' corporation should be entitled to parity or not. Upon such adjudication the state court is compelled to enter its judgment providing for distribution, not in accordance with state law, but as provided in the federal plan. Although respondents assert that the substantive rights continue as they existed prior to the filing of the petition, such assertion is refuted by their own recital of those provisions of the plan which modified those rights.

It is certainly more reasonable to recognize the fact that since the agreement as to the disposition on parity or subordination was an integral part of a federal plan, it was the intent that the determination of the legal status which would place into operation either formula for distribution would be established under the same statute pursuant to which the agreement was made effective.

No party in interest has controverted the statement that the reservation of the parity question was agreed upon solely to eliminate delay in consummating the plan. Nor may it be argued reasonably that the carrying out of such purpose effected an adverse change in the rights of petitioner to have the question determined as a matter of federal law under which its predecessor, the bankruptcy trustees of the guarantor, would have been entitled to parity.

2. It is argued that the New York rule is a rule of substantive law binding on the federal courts; that the doubt existing at the time of this Court's decision in the *Geist* case, *supra*, as to whether the New York rule is one of distribution has now been dissipated; that this Court is bound therefore to follow the rule as clarified by the New York Court of Appeals in the present case; and that the evidence of "actual intent" as implied by the New York court here concludes the issue.

An examination of the opinion in this case, however, negatives each conclusion of respondents. Presented with this Court's analysis of the New York rule in the *Geist* case, *supra*, the New York court did not question any portion of such analysis. It did not treat the rule as one misinterpreted by this Court, but reiterated its prior statements contained in decisions referred to in the *Geist* case, and which this Court characterized as establishing a rule of distribution.

Rather than asserting that its decisions were binding on the federal court, the New York court here affirmatively recognized that the federal plan or bankruptcy court order could determine the parity question as one of federal law, and held that only since, in its view, no such determination had been made, the basis for decision was therefore the state rather than the federal law (*Ferris* v. *Prudence Realization Corporation* [R. 366, 367], 292 N. Y. 210, 218).

On the question of alleged "actual intent", the documents contained in the record and discussed by the New York

Court of Appeals refute the conclusion that in this case there was actually an agreement by the guarantor to subordinate its certificates.

The certificates provide:

> "The share or part in said bond, mortgage and extension agreement represented by this certificate, is not and shall not be subordinate to any other share or shares thereof, and is not and shall not be subject to any prior interest therein" (R. 48),

and further:

> "The Corporation, The Guarantor and The Bank of America, New York, for their respective corporate accounts, may be the holder or pledgee of similar shares in said bond and mortgage, as extended" (R. 50).

They further provide:

> "1. The Corporation and/or The Prudence Company, Inc., hereinafter called the 'Guarantor,' are irrevocably authorized to collect all moneys payable under the terms of said mortgage; credit said bond, mortgage and extension agreement with payments thereon and in its own name to satisfy or assign said mortgage upon payment thereof; account to the holder of this certificate for his share of the principal and for interest at the rate of 5½% per annum thereon, payable under the terms of this certificate and to retain any balance of moneys collected;" (R. 49).

The New York Court of Appeals relied upon the last quotation for its conclusion of "actual intent" to subordinate the guarantor's certificates (*Ferris* v. *Prudence Realization Corporation* [R. 372, 373], 292 N. Y. 210, 222, 223). In reaching that conclusion it ignored the fact that the "controlling" paragraph does not deal with ownership or rights in the certificates and that it provides merely for a servicing agency and for the compensation to be received by the guarantor, not in its capacity as guarantor, but as such agent. It is to be noted that the paragraph is a grant of authority not alone to the guarantor, but to the "Corpora-

tion and/or the Guarantor", and that the language of retention of excess is used in connection with the obligation of either the corporation or the guarantor, not to pay principal or interest in connection with any guaranty, but to "account" for moneys collected as such agent (R. 49). To hold that such agency agreement, contained in the same document which provides clearly for ownership by the guarantor of certificates which shall not be subordinate to any other shares, constitutes a showing of actual intent to subordinate, is to contradict the plain intent of the English language.

Even the New York court recognizes that this language does not constitute "actual intent", for as that court stated in *Title Guarantee & Trust Company* v. *Mortgage Commission*, 273 N. Y. 145, and repeated here (*Ferris* v. *Prudence Realization Corporation*, R. 372, 373, 292 N. Y. 210, 222, 223):

> "The right of the certificate holder to preference in the distribution of the proceeds rests not only upon *presumption of intent* derived from the guaranty of the assignor, but also upon *actual intent clearly implied* in the clause of the certificate which provides that upon the collection of the proceeds of the mortgage by the assignor it shall have the right 'out of the proceeds of such collection to retain so much as may remain after paying to the holder hereof whatever may be due to such holder of principal and interest on this certificate as herein provided.'" (Italics supplied.)

Here again, therefore, the New York rule is one based upon "presumption of intent" and upon actual intent "clearly implied" by the New York court as the basis for applying its rule of subordination. Such a rule is unreasonable in its interpretation and unconscionable in its application and it is submitted that there is no reason for the federal court "to transplant, from the state to the federal courts, a doctrine which is so curiously lacking in logic and fairness as the New York rule of automatic subordination". *Geist* v. *Prudence Realization Corporation* (C. C. A. 2d), 122 F. (2d) 503, 510, dissent by Judge Frank.

The characterization by the state court of its rule as one being predicated upon intent cannot bind the federal court. As was stated by this Court in *Wragg* v. *Federal Land Bank of New Orleans*, 317 U. S. 325, 328:

> "In the interpretation and application of the Bankruptcy Act as in the case of other federal statutes, federal not local law applies. Prudence Realization Corp. v. Geist, 316 U. S. 89, 95, 62 S. Ct. 978, 982, 86 L. Ed. 1293, and cases cited. It is for the bankruptcy court to determine, by reference to the provisions of the bankruptcy statute, what rights created by state law—regardless of the characterization which may be applied to them by state statutes and decisions—are within the jurisdiction of the bankruptcy court. United States v. Pelzer, 312 U. S. 399, 402, 403, 61 S. Ct. 659, 660, 661, 85 L. Ed. 913."

See also, Robertson and Kirkham, *Jurisdiction of the Supreme Court of the United States*, pp. 159-161.

3. These respondents finally argue that within the ruling of this Court in *Prudence Realization Corporation* v. *Geist, supra*, the certificates here involved were acquired by the guarantor as an incident of its guaranty, and must therefore be subordinated. To support the argument, they refer to the fact that the guarantor's financial position was such as to necessitate its application for a $20,000,000 loan from Reconstruction Finance Corporation just prior to its acquisition of the certificates here; that its maturities were increasing and that funds were necessary in order to permit the corporation to meet interest and principal charges; that it invoked the 18 months clause contained in its guaranty as of January 1, 1932, and that the method of acquisition demonstrates the fact that they were acquired by the guarantor in order to reduce its guaranty obligation.

The argument is self-defeating, for the invocation of the 18 months clause which granted to guarantor an opportunity to defer payments of principal until July, 1933,

negatives its intent to pay off maturing securities. Moreover, the record in the present case contains a deposition of a witness called by respondents, which shows that the acquisition of the certificates here was consistent with the practice of the guarantor throughout its corporate existence and that such cerificates were acquired, as were all others, in the usual course of its business and that the primary purpose at all times on the acquisition of all certificates had been and was in this case for the purpose of keeping its customers (R. 243, 244).

Borrowing funds from Reconstruction Finance Corporation was certainly not consistent with any policy on the part of the guarantor to terminate its business but rather to continue it. The securing of such loan was intended to permit the corporation to make interest payments when due, and continue as a going business. The argument that those funds which were required in substantial amounts for the payment of such interest were used for the purpose of paying principal obligations whose maturities were postponed by agreement is inconsistent with such policy and purpose.

An examination of this Court's opinion in the *Geist* case will demonstrate that the reference to the acquisition of securities as an incident of its guaranty was made by this Court in connection with the surety cases cited by the Court at page 96 of its opinion. In the present case, as was true in the *Geist* case, the rights claimed by petitioner in the certificated mortgage were not acquired as an incident of its guaranty, nor are they asserted by way of subrogation. The relationship between the guarantor here and certificate holders was not the customary suretyship relationship considered by this Court in the *Geist* case. The making of the mortgage loan was independent of the guaranty which was given, not at the instance of the borrower, but by the guarantor after the making of the loan. Nor were the certificates or the mortgage here collateral security for the guaranty obligation. The certificates represented an undivided share in the mortgage and upon their

acquisition by Prudence, Prudence became the holder of an interest in a mortgage. That was the precise question raised and determined in *In re The Westover, Inc.* (C. C. A. 2d, 1936), 82 F. (2d) 177. As the record discloses, such interests constituted a substantial portion of its assets, were its sale inventory, and were sold by the guarantor for profit. The manner of acquisition of certificates through a "hidden" brokerage account at substantial discount was necessarily consistent with the purpose of the company in acquiring mortgage interests at less than par for future sale at a profit, and had the guarantor resold the specific certificates here involved, its purchaser would clearly have been entitled to parity.

It is submitted, however, that the discussion of the solvent surety cases by this Court in the *Geist* case and the reference to the fact of the acquisition of its certificates in the *Geist* case by the guarantor as independent of its guaranty, were an incident of this Court's analysis of the equitable rules of distribution applied by the federal court in bankruptcy proceedings. Subordination will be decreed only if it would be inequitable not to prefer a particular group of creditors. *Sampsell* v. *Imperial Paper & Color Corporation*, 313 U. S. 215. There is neither any argument nor any showing in the present case that the failure to give a preference to the *Burnside* certificate holders would be inequitable but, on the contrary, the argument made by respondents indicates that the *granting* of such a preference would be inequitable.

If any of the facts asserted by respondents are assumed to be true, it is clear that the guarantor at the time of acquisition of these securities was either insolvent or imminently insolvent. It must be conceded that in such financial condition its assets were available for pro rata distribution among all of its guaranty creditors including not alone the *Burnside* certificate holders but all other creditors. Defendants-respondents argue, however, that if Prudence took a portion of its assets then available for all creditors and purchased some of its *Burnside* guaranty claims, thereby

preferring such *Burnside* certificate holders, the result must be to benefit the remaining *Burnside* certificate holders to the extent of the certificates acquired by the guarantor from their co-tenants, and to deprive the remaining creditors of the guarantor of their pro rata share not alone of the cash or other assets used to acquire the *Burnside* certificates, but of their equivalent share in the proceeds of such acquisition.

Again, if the certificates acquired through the brokerage account are to be considered as having been acquired in a surreptitious manner at less than par, it is argued that the deception which may have been perpetrated upon the sellers of such certificates to Prudence shall result in a penalty being imposed upon the remaining guaranty creditors for the benefit, not of those deceived, but of the remaining *Burnside* certificate holders who did not join their remaining co-tenants in the sale of securities.

On either aspect, the argument of these respondents rests upon the assumption that improper action by the guarantor in acquiring certificates shall penalize one group of guaranty creditors for the benefit exclusively of another group holding similar guaranty claims. Such a rule is clearly inequitable when it is considered that petitioner is not the guaranty company but the creditors' corporation organized for the benefit of all creditors.

As to whether any preference will result in the event that certificates held by petitioner are subordinated, it is quite evident that the result of subordination in the present case is to grant to *Burnside* certificate holders an opportunity to receive full repayment of the original guaranty obligation at the expense of the remaining creditors of the guaranty company all of whom held similar guaranty agreements. No equitable basis for such preference is established by respondents. It is submitted, however, that the argument for subordination, predicated as it is upon improper conduct of the guarantor toward all creditors may not properly be utilized to benefit one group at the further expense of the remaining creditors.

III

The arguments made by respondents show the existence of a federal question which, it is submitted, has been erroneously decided by the New York Court of Appeals. There are other reorganization proceedings pending presently in the federal courts, in which petitioner is involved, and in which the same question will be raised. In each case a substantial number of certificate holders are involved and unless the present status of petitioner's certificates is clarified, continued litigation will ensue at the expense of all creditors including those petitioner represents. The argument made by defendants-respondents as to the controlling effect of the New York decision in federal court reorganizations will undoubtedly be raised, as it already has been, in federal court litigation, not alone with respect to the parity question but with other questions of state law and the binding effect of such decisions on the federal court.

Prior to the decision rendered in the instant case by the New York Court of Appeals, it was recognized that this Court's decision in *Prudence Realization Corporation* v. *Geist*, *supra*, clearly established the basis to be adopted by the federal courts in the treatment of creditors' claims in bankruptcy, where such rights were based upon either state decisions or statutes. The New York Court of Appeals in the instant case has thrown doubt on that basis. The denial of the instant petition, although it would not constitute a determination by this Court that its prior decision in the *Geist* case, *supra*, has been overruled or modified, nevertheless would be construed generally as casting doubt upon the decision in the *Geist* case. Whatever the Court's ultimate disposition of the instant case may be, it is submitted that for the purpose of clarification of bankruptcy administration, the present petition should be granted and this Court make a clear announcement of the status of creditors' rights.

Conclusion

WHEREFORE, your petitioner prays that its petition for a writ of certiorari should be granted and that the judgment entered in the Supreme Court of the State of New York, County of New York, should be reversed.

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August, 1944.